No. 79-584

In the Supreme Court of the United States

OCTOBER TERM, 1979

RESEARCH EQUITY FUND, INC., PETITIONER

v.

THE INSURANCE COMPANY OF NORTH AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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This brief is filed in response to the Court's invitation to the Solicitor General to express the views of the United States.

QUESTION PRESENTED

Whether, in the circumstances of this case, a portfolio manager provided to an open-end management investment company by its investment adviser is an "employee" of the investment company within the meaning of Securities and Exchange Commission Rule 17g-1, 17 C.F.R. 270.17g-1, promulgated under Section 17(g) of the Investment Company Act of 1940, 15 U.S.C. 80a-17(g), and is thus subject to the fidelity bonding requirements of those provisions.

STATEMENT

Petitioner, an open-end management investment company (commonly known as a mutual fund), brought suit to recover on fidelity bonds for losses suffered as a result

of the dishonest acts of its portfolio manager, A. Stephen Sanders, whose services were provided to petitioner by its investment adviser under a management contract.[1] The fidelity bonds involved in this case were joint investment company-investment adviser bonds issued by respondent. The district court entered judgment in favor of respondent (Pet. App. 11a-47a), and the court of appeals affirmed (*id.* at 1a-10a).

The court of appeals found that Sanders was among the persons whose acts were covered by the fidelity bonds (Pet. App. 4a). The court nonetheless concluded that the "trading loss" exclusion contained in the bonds would bar recovery for losses resulting from Sanders' acts unless, as "statutory bonds," the bonds must be given a broader interpretation by virtue of SEC Rule 17g-1, 17 C.F.R. 270.17g-1, adopted under Section 17(g) of the Investment Company Act of 1940, 15 U.S.C. 80a-17(g) (Pet. App. 6a).[2]

The court then analyzed the scope of the bonding requirements imposed by Rule 17g-1. The court concluded that Sanders had committed "larceny" and "embezzlement" within the meaning of Rule 17g-1 and accordingly that the loss suffered by the fund was the

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[1]Sanders caused the investment company to purchase securities with knowledge that the prices of those securities were being manipulated and without regard to their investment merits. In return for this action, he received payments from the persons engaged in the manipulation (Pet. App. 24a).

[2]"Statutory bonds" are bonds obtained to satisfy a duty prescribed by statute. A statutory bond is interpreted to conform to the requirements of the statute under which it is obtained. See Pet. App. 6a; *Index Fund, Inc.* v. *Insurance Company of North America*, 580 F. 2d 1158, 1162 (2d Cir. 1978); *American Casualty Co.* v. *Irvin*, 426 F. 2d 647, 650 (5th Cir. 1970).

type of loss for which bonding is required (Pet. App. 7a).[3] It nonetheless held that the statutory bond doctrine would not support recovery in this case because "the statute does not require coverage for the losses suffered * * * at the hands of someone such as Sanders * * *" (Pet. App. 10a).

In the court's view, Sanders was not properly regarded as one of petitioner's "employees," but instead was solely an employee of its investment adviser (Pet. App. 7a-10a). While the court recognized that mutual funds generally do not have employees of their own and rely on their advisers' employees to perform managerial and administrative functions (Pet. App. 8a), it concluded that Rule 17g-1 does not require mutual funds to be bonded for larceny or embezzlement committed by the employees of their advisers (Pet. App. 8a-9a).

DISCUSSION

1. In our view, the court of appeals' interpretation of the term "employee" as used in Rule 17g-1 is overly restrictive and erroneous. Moreover, the issue presented by this case is an important one because the bonding requirements of the Investment Company Act provide essential protection for investors.

As the court of appeals recognized (Pet. App. 7a), Congress intended to grant the Securities and Exchange Commission authority to impose bonding requirements to protect mutual funds and their shareholders from larceny and embezzlement, including activities of the kind in which Sanders engaged. Rule 17g-1, which reiterates the language of Section 17(g) of the Act, imposes such requirements. Yet as a result of the court

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[3]See *Index Fund, Inc.* v. *Insurance Company of North America*, *supra*, 580 F. 2d at 1163.

of appeals' decision, petitioner and its shareholders have been denied the protection of bonding simply because petitioner was managed by personnel who were hired by an adviser with whom petitioner had a management contract.

The court of appeals recognized that the relationship between petitioner and its investment adviser—a relationship in which the adviser provided management services through personnel who "functioned as if they were * * * [the investment company's] employees"—is "the norm in the industry" (Pet. App. 8a).[4] Under these circumstances, as the Commission stated in its memorandum in support of the petition for rehearing in the court of appeals:[5]

> [T]he result of the [court of appeals'] holding is that (i) the bonding requirements would have minimal application to [mutual funds managed by an external advisory firm] and (ii) their applicability would be dependent upon whether the company happens to be managed internally rather than by an external advisory firm. Congress could hardly have intended such an anomalous result.

[4]See *Burks* v. *Lasker*, 441 U.S. 471, 480-481 (1979) ("'[m]utual funds, with rare exception, are not operated by their own employees. Most funds are formed, sold, and managed by external organizations, [called 'investment advisers,'] * * *. The advisers select the funds' investments and operate their businesses * * *,'" quoting S. Rep. No. 91-184, 91st Cong., 1st Sess. 5 (1969)).

[5]The Commission participated as amicus curiae in this case in support of petitioner, filing a memorandum in the district court, a statement of its views in the court of appeals, and a memorandum in support of rehearing in that court.

By placing the corrupt activities of the adviser's employees beyond the reach of the bonding requirements of Rule 17g-1, the court of appeals failed to interpret those requirements "in a manner most conducive to [their] goals." *United States* v. *National Association of Securities Dealers, Inc.*, 422 U.S. 694, 720 (1975).[6]

2. Although we believe that the issue presented in this case is important and the decision of the court of appeals is erroneous, we note that the decision below is the only appellate decision dealing with this issue. Moreover, the decision was rendered in the absence of a Commission rule explicitly addressing the question whether bonding is required for personnel furnished to a mutual fund such as petitioner by its adviser. In our view, the problem created by the court of appeals' decision can be corrected by the Securities and Exchange Commission through rulemaking in the exercise of its "broad regulatory authority over the business practices of investment companies." *E.I. du Pont de Nemours & Co.* v. *Collins*, 432 U.S. 46, 52 (1977), quoting *United States* v. *National Association of Securities Dealers, Inc.*, *supra*, 422 U.S. at 704-705.

[6]In construing the term "employee" under other statutes, this Court has recognized that the term "derives meaning from the context of [the] statute, which 'must be read in the light of the mischief to be corrected and the end to be attained.'" *NLRB* v. *Hearst Publications, Inc.*, 322 U.S. 111, 124 (1944). See also *United States* v. *Silk*, 331 U.S. 704, 712 (1947) ("the term[] 'employee' [is] to be construed to accomplish the purposes of the legislation. * * * [A] constricted interpretation of the phrasing by the courts would not comport with [the legislative] purpose.").

Throughout the Investment Company Act, Congress has granted the Commission broad rulemaking powers. In addition to numerous specific grants of rulemaking authority,[7] Section 38(a) of the Act, 15 U.S.C. 80a-37(a), empowers the Commission to "make * * * such rules and regulations * * * as are necessary or appropriate to the exercise of the powers conferred upon the Commission" under the Act. Section 38(a) also grants the Commission authority to define "technical" and "trade" terms used in the Act.

Further specification of fidelity bonding requirements under the Act is a matter requiring the Commission's administrative expertise. Section 17(g) of the Act is not self-executing. It is only through the exercise of the Commission's rulemaking authority under that provision that bonding is required at all. In light of the technical nature of bonding requirements, it is appropriate for the Commission to develop rule proposals that would fill the gap in protection created by the court of appeals' ruling, as well as any other inadequacies in the industry's

[7]See Sections 6(c), 6(d), 8(b), 8(c), 8(d), 10(e)(3), 10(f), 11(a), 12(a), 12(b), 17(d), 17(e)(2)(C), 17(f), 17(g), 17(j), 18(f)(1), 18(j)(2), 19(a), 19(b), 20(a), 22(b)(2), 22(c), 22(e)(3), 22(f), 23(b), 23(c)(3), 24(a)(1), 24(c), 24(d), 24(e)(3), 24(f), 27(b), 27(d), 27(e), 27(f), 28(a)(2)(G), 28(b), 28(c), 28(d)(5), 30(c), 30(d), 30(e), 31(a), 31(c), 32(c), 38(b), 40(c), and 45(a) of the Investment Company Act of 1940, 15 U.S.C. 80a-6(c), 80a-6(d), 80a-8(b), 80a-8(c), 80a-8(d), 80a-10(e)(3), 80a-10(f), 80a-11(a), 80a-12(a), 80a-12(b), 80a-17(d), 80a-17(e)(2)(C), 80a-17(f), 80a-17(g), 80a-17(j), 80a-18(f)(1), 80a-18(j)(2), 80a-19(a), 80a-19(b), 80a-20(a), 80a-22(b)(2), 80a-22(c), 80a-22(e)(3), 80a-22(f), 80a-23(b), 80a-23(c)(3), 80a-24(a)(1), 80a-24(c), 80a-24(d), 80a-24(e)(3), 80a-24(f), 80a-27(b), 80a-27(d), 80a-27(e), 80a-27(f), 80a-28(a)(2)(G), 80a-28(b), 80a-28(c), 80a-28(d)(5), 80a-29(c), 80a-29(d), 80a-29(e), 80a-30(a), 80a-30(c), 80a-31(c), 80a-37(b), 80a-39(c), and 80a-44(a).

present bonding practices. See generally *Mourning* v. *Family Publications Service, Inc.*, 411 U.S. 356, 369 (1973); *National Muffler Dealers Ass'n* v. *United States*, 440 U.S. 472, 476-477 (1979).[8]

The Commission is currently developing rule proposals and is considering the initiation of rulemaking proceedings. The Commission has already brought to the industry's attention certain problems created by a restrictive interpretation of the bonding requirements. Following the district court's decision in this case, the Commission issued a release, expressing the views of its Division of Investment Management, which recommended that the disinterested directors of mutual funds review fidelity bonds now in effect in light of "their fiduciary responsibilities under the Act to assure that the investment companies which they serve have fidelity bond coverage which both satisfies the requirements of * * * Rule [17g-1] and offers adequate protection to shareholders." Investment Company Act Release No. 10393 (Sept. 8, 1978), 15 SEC Docket 1082, 1085.

[8]In light of the purpose served by bonding and the common practice in the mutual fund industry for investment advisers to furnish mutual funds with personnel, a regulation defining the term "employee," as it is used in Section 17(g) and Rule 17g-1, to include such personnel may be appropriate. See Rule 17g-1(i) under the Investment Company Act of 1940, 17 C.F.R. 270.17g-1(i), defining the terms "officer" and "employee" to include officers and employees of an investment adviser to an unincorporated open-end management investment company. See also Investment Company Act Release No. 214 (Sept. 15, 1941), expressing the view of the Commission's General Counsel that the term "employee," as it was used in Section 10(a) of the Investment Company Act of 1940, 54 Stat. 806 (current version at 15 U.S.C. 80a-10(a)), includes attorneys on a general retainer from an investment company.

CONCLUSION

While we are of the view that the decision of the court of appeals is erroneous and that the question involved is important, we believe that review by this Court at this time is not essential in light of the Commission's rulemaking authority.

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